THE FEDERAL BANKRUPTCY LAW.

AFTER nearly twenty years of agitation and effort, the advocates of federal bankruptcy legislation have carried their point. The conference report on the Torrey-Henderson bill was adopted by Congress toward the close of its last session, and by the signature of the president, July 1, it became a law.

It was not the intention of Congress, in passing this measure, to make temporary provision for the relief of the legions of insolvent debtors, victims of the long period of financial depression, and to repeal the law again when this purpose should be accomplished: on the contrary, the intention was to establish, for the adjustment of the mutual rights and obligations of debtors and creditors, a system of bankruptcy legislation which, it was hoped, would become a permanent part of our national jurisprudence.

It may be of interest, then, to review some of the considerations involved in the passage of a national bankruptcy law — the need of it, the power of Congress to enact such a law, a few of the causes of the opposition in Congress to legislation on this subject, and the defects that have proved fatal to previous acts and have caused their repeal. Finally, it may be worth while to examine some of the provisions of the law of July 1, 1898, by which its authors, in the light of experience, have attempted to avoid the mistakes and correct the abuses of former laws.

A bankruptcy law which is to be permanent should be framed in the interest of the whole community and not of any one class, whether debtors or creditors. It should have three principal ends in view. In the interest of the creditors, it should effect an equitable distribution of the debtor's property. In the interest of the honest but unfortunate debtor, as well as of the community, it should secure for him a discharge from his

obligations. In the interest of the community, as well as of the creditors, it should discover and prevent any fraud either by the debtor or by one or more of his creditors. The first requirement is based on strict justice, and its importance is universally recognized in continental Europe as well as in England and the United States. The second is justified by public policy and expediency, as well as by a broad humanity, but is not so generally recognized. The justice and expediency of the third cannot be questioned. Neither the law of 1800 nor that of 1841, however, fulfilled these requirements: the former was in the interest of the creditors, the latter in the interest of the debtors.

From the point of view of the public interest, the theory of a discharge is that an undischarged bankrupt, burdened with an incubus of debt, has no incentive to gain more than a mere livelihood; nor will he be likely to receive assistance from relatives or friends, when hordes of hungry creditors stand ready to pounce upon his acquisitions. From this condition of affairs the creditors reap no benefits; and the hopeless debtor is a dead weight upon the community. The discharged bankrupt, on the other hand, will begin again with renewed courage to capitalize his skill and industry, and the community will not be deprived of his labors. Under this theory a discharge will, of course, be refused to a fraudulent bankrupt, as his labors are of no value to the public. As to the principle involved, Story says:

> One of the first duties of legislation, while it provides amply for the sacred obligation of contracts and the remedies to enforce them, certainly is, *pari passu*, to relieve the unfortunate and meritorious debtor from a slavery of mind and body, which cuts him off from a fair enjoyment of the common benefits of society and robs his family of the fruits of his labor and the benefits of his paternal superintendence. A national government which did not possess this power of legislation would be little worthy of the exalted functions of guarding the happiness and supporting the rights of a free people. It might guard against political oppression only to render private oppressions more intolerable and more glaring.[1]

[1] Commentaries on the Constitution, § 1106.

From any of the foregoing points of view the insolvent laws of our states are necessarily inadequate. In the first place, they cannot secure equality among the creditors. The doctrine of the American courts has come to be this: that a domestic creditor or a foreign suitor, who has attached his debtor's property within the jurisdiction of the court, is to be preferred to the trustee or assignee of a foreign bankruptcy, even though his attachment was secured subsequently to the adjudication of the foreign bankruptcy; and that for this purpose the states of the Union are foreign to one another. This is not an application of the principles of international private law, for the rule has been applied between citizens of different states having similar laws upon the subject. It simply expresses the determination of the courts to give preference to their own citizens and to suitors within their own jurisdiction.

In the second place, a discharge granted by a state law does not release the debtor from debts to foreign creditors, unless they have come within the jurisdiction and have proved their claims in bankruptcy. This means, of course, that in many cases a discharge under a state insolvency law is virtually worthless, since the majority of a debtor's creditors may reside without the state of his residence, from whose courts he has received his discharge.

In the third place, many of the states have made no provision for annulling fraudulent conveyances made on the eve of insolvency; and preferences benefiting one creditor at the expense of others are allowed in Florida, Georgia, Indiana, Mississippi, Montana, Nevada, New Mexico, New York, North Carolina, Ohio, Texas, Utah and Virginia, and in the District of Columbia.

When we consider the steady increase and ramification of our interstate commerce and the evils that may arise from the multiform state laws, the far-seeing wisdom of the builders of our constitution becomes apparent. The Constitution of the United States gives Congress power "to establish uniform laws on the subject of bankruptcies throughout the United States." This is, therefore, not an implied power, but one that has been

expressly granted by the states to the federal government. It is practically exclusive, since it is only by congressional action that uniform laws can be established. It has been decided, however, that the enactment of a national law does not extinguish, but merely suspends, the state statutes, and that these become operative again whenever the congressional act is repealed.

Question arose at an early period as to the scope of this power. The answer depends on the interpretation given to the word "bankruptcies." At the time of the adoption of our constitution, the terms "bankruptcy" and "insolvency" had quite distinct meanings in England. Imprisonment for debt existed in that country; and insolvent laws were intended to afford a debtor thus confined an opportunity to regain his freedom by asking for a discharge and offering to surrender all his property for distribution among his creditors. Bankruptcy, on the other hand, had a more technical meaning. Bankruptcy laws, which had appeared with the higher development of commerce, were applicable solely to traders, could be put into operation only by creditors and had the effect of discharging the debts as well as the person of the debtor. The two systems did not, however, differ as regards the surrender and administration of the debtor's property. The strict constructionists in the United States claimed that the word "bankruptcy," as used in the constitutional grant to Congress, should be limited in meaning to the narrow English sense; but at an early date the courts decided that this clause was to be construed as giving power to Congress to adjust the affairs of all insolvent debtors.

The first exercise by Congress of the constitutional grant of power was the act of April 4, 1800, which was modelled after the English statutes existing at that date and was a bankrupt law in the narrow sense. It provided only for involuntary bankruptcy, or, in other words, for bankruptcy resulting from the petition of the creditors; it was applicable only to merchants and traders; and it was very harsh in its treatment of the debtor. This law was limited to five years and from thence to the end of the next session of Congress; but it was repealed within that period by the act of December 19, 1803.

In the spring of 1840 another effort was made to establish a uniform system of bankruptcy. The purpose of Congress was to enact a measure for the relief of the thousands of debtors who had been ruined during the financial and commercial panic of 1837-38, and for whose relief the state laws were inadequate. The bill that was reported was in the interest of debtors only: it aimed to establish a system of voluntary bankruptcy that would enable debtors of every description to secure discharges from their debts without the consent of any of their creditors. This bill was opposed by some because, as they alleged, it would enlarge the powers of the federal courts, increase the federal patronage and lead to corruption and abuse. The constitutionality of the measure was attacked, on the ground that the power granted by the constitution to Congress was incidental to the regulation of commerce and was to be applied only to merchants and traders. It was also argued that the term "bankruptcy" must be taken in the restricted English sense as meaning an involuntary system for the benefit of creditors only, to be put into operation solely by them. The construction that had been put upon the term by the law of 1800 was proof, they said, of the intention of the makers of the constitution. It was further maintained that a provision for involuntary bankruptcy was necessary to protect the rights of creditors.

The advocates of the bill, on the other hand, contended that it would benefit creditors, inasmuch as it would effect an equitable distribution of the debtor's property among his creditors; that the term "bankruptcy" meant failure and applied to persons of every description who had become insolvent; and that the constitution did not intend to restrict Congress to the passage of a law providing for involuntary bankruptcy only and applicable to traders only, like the English law of that period, but aimed to give Congress power to adjust the affairs of all insolvent debtors.

At the next session of Congress a national bankrupt law was passed, the act of August 19, 1841. It contained a clause for voluntary bankruptcy that applied to all debtors and one for involuntary bankruptcy, applicable only to debtors who were

merchants or traders and who had committed certain fraudulent acts. Any person residing within the United States who had debts not created in consequence of a defalcation as a public officer, or as an executor, administrator, guardian or trustee, or while acting in any other fiduciary character, might declare his inability to meet his obligations; and might, by petition on oath setting forth a list of his creditors and an inventory of his property, apply to the proper district court for the benefit of the act. Any merchant, trader, banker, broker, underwriter or marine insurer, who had debts to the amount of $2,000, was liable to become a bankrupt upon petition of one or more of his creditors to the amount of $500, provided he had absconded or fraudulently removed or concealed or assigned or sold his property. When duly discharged, the bankrupt was declared to be free from all his debts.

This provision for involuntary bankruptcy did not satisfy creditors, since it gave them no means of opening bankruptcy proceedings against debtors who were fraudulently disposing of their property, unless they chanced to be merchants or traders. The law was therefore repealed March 3, 1843, after a life of only thirteen months.

During the existence of the act of 1841, the constitutional power of Congress to enact a voluntary bankrupt law was passed upon by the courts, and it was decided that the voluntary as well as the involuntary clauses of the act were constitutional. This question has never been revived.

The act of 1867 was intended to benefit both debtor and creditor — to secure equality, by forbidding preferences to favored creditors and by dissolving all recent attachments upon the debtor's property; and to improve the condition of honest debtors, by giving them discharges on certain conditions. It contained provisions for both voluntary and involuntary bankruptcy, and the involuntary clause was made applicable to non-traders as well as to traders.

In 1874, however, this law was amended by Congress in a way that made it very difficult and expensive for creditors to force debtors into bankruptcy. It was made necessary for one-

fourth in number and one-third in value of the creditors to unite in the petition to have a debtor adjudged a bankrupt. The obstacles in the way of procuring the joint action of so many creditors rendered the involuntary clause practically useless, and the law became virtually a system of purely voluntary bankruptcy, with all of its attendant evils. Rather than submit to so much trouble and delay, creditors preferred to rely upon their ordinary legal remedies of judgment and attachment. So slow, moreover, was the procedure and so exorbitant were the fees paid to the various officials, that the bankrupt's estate was wasted and the creditors realized little or nothing.

After the repeal of this law in 1878, unremitting efforts were made to secure the enactment of a national bankruptcy law, which, by strengthening credit, by facilitating the collection of debts and by granting to the honest but unfortunate debtor a discharge from his burden of liabilities, should conserve the interests of all classes of the community — a law which should prevent imposition on the one hand and oppression on the other. These ends, it is believed, are fairly secured by the present law. Originally prepared by Col. Jay L. Torrey, of Wyoming, it was introduced in the last Congress, with various modifications, as the Henderson bill, and after still further amendment it became a law on July 1, 1898. It provides for both voluntary and involuntary bankruptcy, and, with certain exceptions, it is applicable to both traders and non-traders.

The opposition to this bill came mainly from those sections of the country which buy on credit and sell for cash, and was directed chiefly against the provision made for involuntary bankruptcy. The representatives of these sections desired a system of purely voluntary bankruptcy. They introduced various bills — for instance, the Culberson and Bailey bills — that were intended as temporary relief measures, necessitated by a period of financial depression and to be repealed again when business prosperity should have returned.

The objection to a purely voluntary system of bankruptcy lies in the opportunity it offers to a dishonest debtor to commit frauds. A man with knowledge of his insolvency may deliber-

ately prepare for bankruptcy. With the connivance of friends and relatives he may convey away his property ; may confess judgments or suffer them to be procured against him ; may wait until the period during which such acts may be attacked — two to six months — has expired ; and then, by filing a petition for voluntary bankruptcy, may perhaps secure a discharge from his debts. Even if a discharge is refused him, his property will have vanished and those who have trusted him will receive nothing. Such was the experience of this country under the laws of 1841 and 1867. The provision for involuntary bankruptcy, however, enables creditors to prevent this by themselves opening bankruptcy proceedings, whereby the debtor's fraudulent acts are annulled and his property is restored to the estate and administered for the equal benefit of all his creditors.

As a matter of precedent, a system of voluntary, unaccompanied by involuntary, bankruptcy exists nowhere in Europe ; and there are only four states in this country which have anything approaching it — namely, Oregon, Wisconsin, Idaho and New York. On the other hand, the double system is found in England, in all the continental European countries and in California, Connecticut, Maine, Massachusetts, Maryland, Minnesota, Nevada and Vermont.

The friends of involuntary bankruptcy have been divided into two parties : (1) Those who favor it only when a debtor has committed an act essentially fraudulent—for example, secreting his person or property to defeat his creditors ; or, when already insolvent, preferring one creditor at the expense of others ; or procuring judgment or suffering judgment to be entered against him with intent to defeat creditors, *etc.* (2) Those who favor it also when the debtor has committed certain acts which result merely from his inability to meet his obligations — for instance, suspending payment of his commercial paper when due ; failing for a certain time to secure the release of any property levied upon, *etc.* Under the Nelson bill, which was supported by a majority in the Senate, fraudulent acts only were recognized as furnishing ground for involuntary bankruptcy ; while

under the Torrey bill, as originally introduced in the House, both classes of acts were so recognized. In order to effect a compromise between the Senate and the House, the acts of bankruptcy of the second class were one by one stricken from the Torrey bill; so that, by the law as finally enacted, creditors cannot force bankruptcy upon an unwilling debtor until he has committed an act that is essentially fraudulent.

As has been the case in the discussion of all former bankrupt laws, it was urged, in opposition to the present law, that it would enlarge the jurisdiction of the federal judiciary. There is, however, no virtue whatever in this contention. The Constitution of the United States gives Congress power to pass a uniform law. It also gives to the federal courts jurisdiction over cases arising under the laws of the United States. Congress, then, in passing such a law does not extend the jurisdiction of the federal courts: it merely enables them to exercise a jurisdiction conferred upon them by the will of the sovereign people, expressed through the constitution. Furthermore, as a practical matter, a law can be uniformly administered only when it is administered by a single system of courts, with a single court of last resort to interpret it in the last instance. A law administered and interpreted by forty-five independent judiciaries would soon cease to be uniform. The law of 1898 has, moreover, carefully guarded the rights of the state courts, and does not in any way interfere with their jurisdiction over controversies between trustees of bankrupt estates and parties claiming adverse interests.

Those who have sought to limit the jurisdiction of the federal judiciary have from time to time presented measures such as the Culberson and Bailey bills. The latter provided for voluntary bankruptcy only. Under it an insolvent debtor might make an assignment valid according to then existing laws of his state; and might then petition the United States district court of his district for a discharge, which would be granted by the judge if he were satisfied that the assignment had been *bona fide* and for the equal benefit of all the creditors. In other words, the proceedings were to be made complicated and

expensive by being conducted partly in one forum and partly in another; the federal and the state courts were to be brought into conflict ; and the way to a discharge was to be made very easy by placing the creditors at the disadvantage of opposing the discharge in one forum on the ground of the debtor's conduct while within the jurisdiction of another. Strangely enough, this bill emanated from the party favoring the strict construction of the constitution, which in 1840 opposed the enactment of a voluntary bankrupt law on the ground of its unconstitutionality.

To meet the objection that has been constantly urged against former laws — that it was inconvenient and expensive for suitors to travel long distances to the seat of the federal courts — the law of 1898 provides that the courts shall designate, and from time to time shall change, the limits of the districts of referees, so that each county where the services of a referee are needed may constitute at least one district, thus bringing the federal courts home to the people.

Among the chief causes of popular discontent with the two preceding acts, and more particularly with that of 1867, were the protracted delays in the proceedings and the numerous and exorbitant fees paid to officials. These abuses led many thinking people to the conclusion that a bankrupt law that would be satisfactory in this respect could never be framed. It has even been said upon the floor of Congress, during a burst of florid oratory, that a bankrupt law was for the benefit of neither creditors nor debtors, but for the benefit of the rodents who infest the places of justice. In the law of 1898, however, a method of compensating referees and trustees has been adopted which, it is believed, will reduce the expenses to a minimum, and will make it the interest of these officials to effect a speedy termination of bankruptcy proceedings and to realize the largest possible dividends for the creditors. Referees are to receive as compensation for their services a fee of ten dollars, deposited with the clerk at the time the petition is filed and payable to the referees after their services are rendered; and from estates administered before them they are to receive

one per cent commission on sums to be paid as dividends, and a commission of one-half of one per cent on the amount to be paid to creditors on the confirmation of a composition. In order further to reduce the expenses, the courts are empowered to appoint and remove the referees in their discretion, thus making the staff of referees an elastic body that will expand or contract in accordance with the needs of the service. Trustees are to receive a fee of five dollars and such commissions as may be allowed by the courts. These commissions, like those of the referees, are to be computed, not upon the total outgo of the estate, but upon the sums actually paid to the creditors as dividends; and they are not to exceed three per cent on the first $5,000, two per cent on the second $5,000 and one per cent on payments in excess of $10,000. Here again the compensation is to be paid after the services have been rendered. The clerk will receive but a single fee, which will be paid to him in advance; and he will have no interest in delaying the proceedings, but will be anxious to have the estate administered as quickly as possible. Since marshals and district attorneys are already salaried officers, every temptation for the officials charged with the administration of the law to exact exorbitant fees or to delay the work has been removed.

The payment of any fees may be avoided by one who wishes to avail himself of the law as a voluntary bankrupt, if he accompanies his petition by an affidavit stating that he does not possess and cannot obtain the money to pay such fees. To such an extent, indeed, have the fees been reduced under the present law that it is seriously doubted by many whether it can be effectively administered.

The practical working of the new law will doubtless disclose opportunities for further amendment, but in its general plan it embraces those features which should be found in a bankrupt law that is to subserve the best interests, not alone of business men who give credit, but of the whole people.

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